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FOMC Briefing
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As Mike noted at the end of his briefing, under the staff forecast the Committee will have to tighten at some point. The question for today's meeting is has that point arrived? Put another way--you've had an asymmetrical directive for about nine months, is it time to deliver?

One approach to this question is to ask what is different now than at the last few meetings that might tip the scales to tightening. That is, do the data in hand now suggest a sufficiently greater risk of inflation to justify an immediate tightening, or, do recent developments still look ambiguous enough to justify retaining a wait and see posture. In broad terms, a key difference now is that economic growth has unexpectedly exceeded the estimated growth of potential in recent quarters, and quite possibly may continue to do so. At the same time, however, high output growth has not raised actual resource utilization rates, and price increases have remained subdued, with remarkably few early signs of potential price acceleration.

The case for standing pat rests importantly on these latter observations. First, the unemployment and capacity utilization rates held steady over the second half of 1996 and early 1997 in the face of even more rapid economic growth than the staff projects for the quarters ahead. To be sure, this resulted from a substantial and unexpected increase in labor force participation and possibly a pickup in productivity growth, which are always difficult to predict. It's possible that, with economic growth expected to slow, further such gains, even if more moderate, could continue to hold down resource utilization for some time.

Second, at relatively low unemployment rates, there has been little evident increase in inflationary pressures. In labor markets, compensation did not accelerate much in the second half of the year; by some measures, it slowed. And core inflation actually declined. Because of the low inflation, the Taylor rule suggests that policy now is roughly in line with your past responses to realized output gaps and inflation rates--responses that have been reasonably successful in damping output cycles and reducing inflation.

The unexpectedly favorable inflation outcomes suggest continuing uncertainties about the level and rate of change in the economy's potential, and about the interaction of that potential with prices. Under these conditions, before it tightened the Committee might wish to see more definitive indications that inflation is likely to pick up absent such a tightening. Such indications might include a further decline in the unemployment rate or a rise in capacity utilization to confirm that growth is, in fact, unsustainable. Presumably the Committee would also be looking for evidence that tight labor or product markets were leading to higher inflation. A further acceleration of compensation, especially if it were squeezing profit margins, would fit in this latter category, as would lengthening lead times or increases in prices at earlier stages of production. In financial markets, money and credit growth at--or certainly above--recent rates might be viewed as confirmation that monetary policy was too accommodative to check the growth of spending.

With policy unchanged, the economy will be allowed to produce marginally more than if the funds rate is raised, and that output might be consistent with sustainable growth. Even if it is not--if it turns out that policy does need to tighten--waiting may not do much lasting damage to inflation, provided that the Committee responds promptly to rising resource utilization or accelerating costs and that inflation expectations do not increase appreciably. Some comfort in that regard may be taken from the fact that inflation expectations of households and businesses seem firmly anchored, and, in the near-term, the expected decline in overall CPI inflation this year should help to keep them from rising very much. And increasing costs may be at least partly absorbed for a while in narrowing profit margins.

In sum, the case for policy remaining unchanged is based importantly on looking at how growth, resource utilization, and inflation have interacted in the immediate past and awaiting new information indicating that this pattern will not persist. By contrast, the case for tightening is built on projected increases in resource utilization and rising inflation pressures under a forecast of continuing strong aggregate demand, combined with the presumption that, based on experience over a longer run, some of the unusually favorable elements that have elevated aggregate supply and restrained inflation in the immediate past are not likely to be carried forward for very long into the future. Even if Committee members do not anticipate a major pickup in inflation under unchanged policy, they may see the higher possibility of persistently strong demand as materially raising the risk of accelerating prices.

One reason demand might be expected to remain quite strong, absent a tightening in policy, is that, in many respects, the financial conditions that produced the above-trend growth of the last few quarters remain in place. For example, the recent rise in long-term interest rates has carried them only to levels that are equal to or even below those that prevailed through much of last spring and summer. Moreover, part of the rise has been predicated on an expected tightening of policy, and real rates would decline if policy remained unchanged. The dollar has been strong, and this is an important reason for the forecasted slowing of economic growth, but on the other side, the stock market also is higher than it was through 1996.

Moreover, credit supply conditions remain quite accommodative. To be sure, there are a few signs that investors have begun to think more seriously about risks: the prices of technology and small capitalization stocks have fallen substantially, inflows to junk bond mutual funds are way off in recent weeks, the yields on securities of emerging market economies have backed up relative to the United States, and spreads of rates on large business loans at banks may have ticked up from very low levels. Nonetheless, exuberance and complacency do not seem to be washing out of the markets to a degree that would raise the effective cost of finance significantly and work to slow spending. Risk spreads in most markets remain unusually low, as Peter showed, price-earnings multiples are still high, and flows of money and credit fairly strong. Bank credit, in particular, has picked up in recent quarters and is feeding through to faster M3 growth. M2 also has grown fairly rapidly on average in recent months. Some outside observers have been putting considerable weight on the recent behavior of money as a signal that the Committee needs to tighten. I'd hesitate to give it quite that degree of emphasis, especially with M2 growth moderating a bit this year. But the recent growth of money does seem more consistent with the 6 percent growth of nominal GDP estimated for the fourth and first quarters than with the under 5 percent growth in the Committee members' forecasts for 1997. More broadly, ample flows of money and credit do tend to confirm the absence of developing liquidity and credit constraints on spending.

If tightening is needed, the longer it is delayed--that is, the longer the economy operates beyond its sustainable potential--the more substantial the offsetting correction in economic activity required if the Committee is to keep inflation from ratcheting higher. To the extent the Committee wishes to focus on its longer-term goal of reducing inflation further, the arguments for tightening would seem to be strengthened. Even if the Committee is not seeking additional disinflation in the near term, or is not sure how low it would like eventually to see inflation fall, so long as the longer-term inflation objective is below the current rate, the Committee would probably view an increase in inflation as more costly than a decrease. In this context, the notion of getting some added assurance that inflation would not rise would be all the more justified.

The financial market reaction to a 25 basis point tightening should be subdued. As Peter noted, it is largely built into the yield curve. Indeed, not tightening could unsettle financial markets as participants reassessed their reading of the signals coming out of the Federal Reserve. A

25 basis point firming may induce markets to extrapolate further such actions, especially as it would represent a shift in direction. This tendency should be limited in the current circumstances, however, because the recent minutes and testimonies have reported your view that policy is probably not greatly out of alignment and because the last string of downward moves was only 75 basis points.

In the past, Committee members have considered whether larger steps would reduce the unsettling effects on markets of waiting for the next shoe to drop. If the Committee were reasonably confident that at least 50 basis points of tightening will ultimately be needed, it might consider the larger step. It would get the desired degree of restraint into the markets more quickly, and it would likely leave the market expecting the Federal Reserve to be on hold for a while, damping market reactions to incoming data over the next few months. At the same time, however, it also would surprise markets and could be read as a message that the Committee is quite concerned about the inflationary potential in the current situation, leading market participants to raise their estimates of the cumulative tightening that may be forthcoming.

A staff study distributed to the Committee in late 1994 found that 25 basis point tightenings did tend on average to have a little more impact on longer rates <u>rela</u>-

tive to the size of the tightening than did larger tightenings, perhaps because of the uncertainty created. That is, a 50 basis point tightening would have slightly less than twice the effect of a 25 point move. Although it is difficult to generalize because of the wide range of experience, it does seem likely that in current circumstances the total market reaction to 50 basis points would be substantially larger than to 25. If the Committee were concerned about the strength of the market response and the possibility that sharp corrections in stock and bond markets could engender their own self-reinforcing dynamic for a while, 25 basis points would seem to be a safer approach, even if more were thought eventually to be needed, accepting the strong possibility that before long markets would begin building in another near-term tightening.

Finally, if the Committee tightens, it needs to consider whether it should retain the asymmetry in the current directive or shift to a symmetric directive. Retaining the asymmetry would seem to imply the Committee had a strong conviction that even after tightening a substantial risk of rising inflation remained and more tightening would be needed. Asymmetry would also seem to mean that the Committee saw that risk as still large enough to trigger further action soon--that the Committee envisioned a fairly steep trajectory for firming. Going to a symmetrical directive might suggest a more cautious approach to further action, perhaps in light of the continued good inflation performance.